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*Providing timely, accurate credit ratings to Institutional Investors*

Prepared Testimony of Sean J. Egan, Managing Director, Egan-Jones Ratings Company
Before the House Financial Services Committee, Capital Markets Subcommittee

April 2, 2003

Chairman Baker, members of the Subcommittee, good morning. I am Sean Egan, Managing Director of Egan-Jones Ratings Company, a credit ratings firm. I am pleased to appear before you to present the views of my firm on the important issues regarding the state of transparency and competition of credit rating agencies being discussed today.

By way of background, I am a co-founder of Egan-Jones Ratings Co., which was established in 1992. We provide credit ratings on a number of issuers of U.S. and international debt and some structured finance transactions. As discussed further below, our business model differs significantly from that of the major nationally-recognized statistical ratings agencies ("NRSROs") in that we are not engaged by the issuer of a security. Instead, our clients consist of approximately 300 national firms consisting mainly of institutional investors and broker/dealers. We are based in the Philadelphia Pennsylvania area, although we do have employees that operate from other offices.

In our view, the current NRSROs recognized by the SEC have failed in their responsibility to provide timely alerts to investors about credit failures over the past couple of years. Market capitalization losses from WorldCom, Enron, Global Crossing and Genuity have been in excess of $200 billion, not to mention the loss of livelihoods and pensions of thousands of employees of these companies. The performance of NRSROs in connection with these corporate failures has fallen far short of an adequate level in protecting investors as witnessed by the following specific failures:

- **Enron** was rated investment grade by the NRSRO's four days before bankruptcy;
- The **California utilities** were rated "A-" two weeks before defaulting;
- **WorldCom** was rated investment grade three months before filing for bankruptcy;
- **Global Crossing** was rated investment grade in March 2002 and defaulted on loans in July 2002;
- **AT&T Canada** was rated investment grade in early February 2002 and defaulted in September 2002; and
- **ABB** was rated "A2" by Moody's as of March 14th 2002 and was rated "Ba2", negative watch as of October 31, 2002. Similarly, S&P rated ABB at "A+" as of March 14th, 2002 and "BBB-", negative watch as of November 5 th 2002.

In addition, investors are becoming increasingly skeptical of credit ratings, and NRSRO ratings in particular. For example, a survey by H. Kent Baker and Sattar A. Mansi published in Table 9 of their June 18, 2001 article Assessing Credit Rating Agencies by Bond Issuers and Institutional Investors indicated that only 29% of bond fund managers believe the NRSRO's update their ratings in a timely manner.

Since other ratings firms succeeded in providing investors with timely warning of the financial problems looming for the issuers noted above, we believe the failures of NRSROs can be attributed to (i) monopolistic conditions, and (ii) the conflicts of interest. Until the flawed structure of the industry is addressed, investors, workers and pensioners can expect additional massive failures to occur without adequate warning from the major ratings agencies. In particular, we believe that the industry is flawed in the following respects:

■ **Monopolistic Conditions/ Ready Opinion Defense -** Moody's and Standard & Poors (S&P) now rate the vast majority of issues and can accurately be described as a "partner monopoly", a term used by the Department of Justice personnel. Unlike the accounting industry where four firms compete for revenues, S&P and Moody's share revenues with respect to the overwhelming majority of ratings since two ratings are normally needed for a debt issuance. In other words, any gain to Moody's does not come at the expense of S&P and vice versa.

The opportunities for maintaining and extending their monopoly are vast since most issuers rely on investment bankers who are reluctant to incur the wrath of the two major NRSROs by recommending another rating firm. In a symbiotic manner, there is a tendency for the rating firms to listen to investment banking firms representing issuers of securities on important issues related to the issuer and, relatedly, to the rating ultimately assigned to a debt issue. For example, prior to finally taking action on Enron, Moody's had a series of conversations with investment banks which stood to gain $50 to $100 million in fees if the Enron/Dynergy transaction was consummated. In the event that any party questions the rating assigned by S&P and Moody's the firms have used the defense that the ratings are merely their opinions.

**Conflict of Interest** – Over the past 15 years, S&P and Moody's have shifted the manner in which they are compensated for their ratings from investor-based compensation to issuer-based payments (according to Moody's 10K, it obtains 87% of its compensation from issuers). In our view, this compensation structure presents conflicts of interest similar to those involving Wall Street equity analysts who were paid via the investment banking fees generated by their firms. With respect to debt ratings, the conflict appears to be particularly acute for large important issues such as the California utilities, Enron, and WorldCom. In these cases investors desperately need unbiased guidance from credit rating firms, but often do not get it because of pressure from issuers, investment banks, commercial banks and in some cases, security exchange officials (see the October 8, 2002 Report of the Staff to the Senate Committee on Governmental Affairs, Financial Oversight of Enron: the SEC and Private-Sector Watchdogs, page 113). In sum, the old adage that "one cannot serve two masters" applies to the ratings field; a firm can either support issuers or investors but not both.

The arguments used by the NRSRO's to defend their actions are the following:

**"Issuer Misdeeds" (they didn't tell us)** – S&P, Moody's, and Fitch did not assign the correct rating to WorldCom, Enron, et al. because these firms did not provide the ratings agencies accurate information concerning their operations. We believe it is a pathetic state when major rating firms are unable to recognize when an issuer and its executives are desperate to keep their firms solvent; for example, it was public knowledge that Bernie Ebbers owed WorldCom more than $400 million. Fraud is present in most failures, and the rating firms (at least those recognized by the SEC) should be able to detect the majority of egregious cases.

**"Little Incentive" (the Jack Grubman defense)** – another argument used by the current NRSRO's to defend their compensation structures is that any one issuer represents only a small portion of their overall revenue base and, therefore, potential conflicts are minimized. However, revenues produced by Jack Grubman and Henry Blodget were likewise only a small portion of CitiGroup's and Merrill's revenues. Furthermore, when large investment banks are pressing the rating firms to hold off on any rating action, it becomes difficult not to listen.

**"Our Reputation is Key" (the Arthur Andersen defense)** – Arthur Anderson argued that it would not do anything untoward because it would hurt the firm's reputation. Likewise, the current NRSRO's argue that they would not risk their reputation for any one issuer. However, since most issuers believe their ratings are too low and press for higher ratings, the lack of competition among rating agencies provides little downside for inaccurate ratings and, therefore, few checks in the industry.

**"Committee Approach" (the Lemming Defense)** – a final defense normally proffered for the flawed industry is that unlike the investment banks, the NRSRO's use a committee approach for assigning ratings, which is harder to manipulate. Unfortunately, normally one analyst typically covers a firm and during rating committee meetings it is probably clear what superiors want in terms of ratings for a company's issuer clients.

**Recommendations**

Employees, pensioners, and investors were badly hurt by the unwarned failure of Enron, Global Crossing, the California utilities and other companies. ; More unnecessary pain can be expected unless and until changes are made in the seriously flawed system in which ratings agencies operate. We recommend the following changes:

**1. Recognize some non-conflicted firms, which have warned investors –** The hearings are an attempt to prevent future Enron and WorldCom failures. The best way is to recognize as NRSRO's rating firms that do not have a conflict of interest with investors and which have succeeded in providing warnings to investors. The current NRSRO's argue that no additional firms should be admitted because it will force them to compete by issuing liberal ratings in an effort to maintain their revenue base. Our view is that rating firms that are compensated by investors are forced to issue timely accurate ratings and that some real competition among ratings firms would improve the industry.

**2. Prohibit issuer compensation** – just as equity research practices were not corrupted until such research was linked to the investment banking practices of broker-dealers and their associated large issuer-based compensation in the form of investment banking fees, existing NRSRO's prior to 1970 obtained most of their compensation from investors rather than issuers. NRSRO's argue that the copy machine made the old business model less attractive because of the ease of distributing ratings. Our response is that there are a number of firms that have thrived without issuer compensation; Sanford Bernstein and Prudential are prime examples on the equity side, and Egan-Jones and Mikuni are examples on the credit rating side.

**3. Prohibit involvement with rated firms and dealers** – Moody's Chairman, Clifford Alexander, served as a director of MCI from 1982 until 1998 and of WorldCom from 1998 until June 2001; WorldCom filed for bankruptcy in July 2002 making it the largest bankruptcy in US history. Officials of credit rating agencies should be prohibited from serving on the boards of those companies that they rate. In addition, such officials should be prohibited from serving on the board such as the National Association of Security Dealers, which represents security dealers (Moody's president, John Rutherfurd, Jr. is listed on the NASD Board of Governors). Dealers' interests are not parallel to investors' interests.

**4. Remove the exclusion from Regulation FD** – rating firms are essentially private research firms and therefore should not be provided with any special treatment when it comes to the dissemination of information to the public by issuers. Information gathered by the monopolistic rating firms for the rating triggers was subsequently distributed only to clients paying for the research portion of the NRSRO's service.

**5. Separate ratings from consulting** – just as accountants were compromised by their consulting assignments, ratings firms have similar issues. Investors and issuers are likely to feel compelled to use the services of S&P and Moody's because of their market dominance.

**6. Prohibit the use of rating triggers** – affording another example of putting issuers' interests ahead of investors', the current NRSRO's were reluctant to downgrade firms because of the fear of setting off rating triggers (see the Enron history).

**7. Prohibit the use of "independent" moniker** – all the current NRSRO's obtain the majority of their compensation from issuers and therefore should not mislead investors by describing themselves as independent.

**8. Police monopolistic practices** – a fair amount of controversy has been generated by Moody's notching (cutting) Fitch's ratings by up to five or six notches in the structured finance area in an attempt to extend its reach. Similarly, it appears as though the large NRSRO's have discouraged major news organizations from carrying ratings or news generated from competing rating firms.

**9. Prohibit providing "color" to investors** – some investors, particularly large investors are given information on analysts' opinions in advance of others.

### A Sampling of Abuses

The problems associated with the lack of competition and conflicts of interest go beyond the Enron, Global Crossing and California utility failures.

**Withholding Ratings** – We received a letter (available upon request) from a senior executive at a brokerage firm whose clients were defrauded by Allied Signal which requested that the rating firms withdraw their rating of an issue of Grimes, an Allied subsidiary, so that investors holding the bonds would be forced to sell (because of the lack of a credit rating), thereby enabling Allied Signal to repurchase the bonds at a lower price. The response given by the rating firms for not rating the bonds was "an official of Allied … told them they [Allied] would be very unhappy if that agency rated Grimes. That rating agency said candidly that Allied was a source of rating income and that they would not jeopardize the relationship".

**Punishment Ratings** – In another variation of the abuses of the NRSRO designation and anti-competitive practices, Moody's in the 1993 assigned an unsolicited and intentionally low rating to some municipal issues which refused to retain Moody's for its ratings services. In these and most other cases, Moody's successfully used the First Amendment protection, arguing that its ratings were merely its opinions and that it was exercising its freedom of speech. Individuals have the right to free speech, but when a monopoly firm employs anti-competitive practices to extend its monopoly, the SEC needs to revoke its NRSRO designation. Because of the dominance of S&P and Moody's it is rare to find parties willing to file a public complaint against them.

**Notching** - Lastly, Moody's in their review of collateralized debt issues has cut the ratings assigned by Fitch by five or more notches while providing little evidence that Fitch's ratings were overly generous. The effect of the action is to discourage the use of ratings from firms other than S&P and Moody's.

### The SEC Review Process

Notwithstanding the problems expressed above with respect to ratings agencies and NRSROs in particular, attaining designation as an NRSRO from the SEC is a critical step, in our view, in remaining competitive as a ratings agency. To this end, our firm currently is pursuing such designation from the SEC staff. We initially applied for NRSRO status in August 1998 and are continuing to provide information to the SEC staff as requested.

As you know, the process of attaining designation as an NRSRO is not objective and involves consideration of many factors. For example, the SEC staff has indicated that the single most important criterion for receiving NRSRO recognition is the acceptance of an applicant in the U.S. as an issuer of credible and reliable ratings by the predominant users of securities ratings. In response, we commissioned a survey to evaluate the extent to which our firm is recognized throughout the market. The SEC was provided with a design of the survey before it was conducted and with the results of the survey in June2002. The results indicated that *we had more than four times the recognition of any other non-NRSRO firm including Dominion Bank,* the rating agency most recently afforded NRSRO status (our market presence is greater now than its was last year).

While we continue to work with the SEC staff on attaining NRSRO status, there are certain fundamental considerations that must be understood to maintain the fairness of the process and ensure that investors receive timely and accurate ratings. First, not all rating agencies use the same business model. As alluded to above, and unlike the current NRSRO's, we are not compensated by issuers for our ratings but instead are compensated by the users of our ratings. From our perspective, this distinction is a good one as we see fewer conflicts associated with our compensation model. Moreover, as noted in the attached pages to my testimony, we successfully flagged most of the major credit failures.

Second, while a ratings agency must have adequate resources to issue reliable, credible and timely ratings, there is no single appropriate level of staffing or capitalization for all rating agencies. Different agencies use varying methods of preparing their ratings. Focusing on the scale utilized by the largest firms not only would ignore this fact, it also would result in a defacto barrier to entry to smaller ratings agencies thereby precluding the competition necessary to spur improvements in this industry.

Thank you very much for the opportunity to appear before you. I'd be pleased to answer any questions you may have.

## Selected Quotes – Egan-Jones Ratings Co.

New York Times
Gretchen Morgenson (Pulitzer Prize Winner) July 7, 2002

“Egan-Jones makes a practice of alerting investors to corporate credit problems well before they are acknowledged by management… As early as November 2000, for example, Egan-Jones cut its ratings on WorldCom to the lowest investment-grade level, citing its deteriorating profit margins and credit quality.”

Fortune’s “Against the Grain”
Herb Greenberg January 21, 2002

“The best balance-sheet snoops are often way ahead of the pack in finding signs of trouble. Sometimes, however, the big credit-rating firms, Standard & Poor's and Moody's, which get paid by the companies they rate, are slow off the mark--slower, as a rule, than independent bond-rating services like Egan-Jones of Wynnewood, Pa...."We don't have the constraint of trying to keep a company happy," says Egan-Jones President Sean Egan, whose downgrade of Enron to junk beat the big guys by about a month.”

Investment Dealers Digest (cover)
Dave Lindorff August 13, 2001

“It didn't take long for Sean Egan, managing director of Egan-Jones Ratings Co., a small ratings agency outside Philadelphia, to figure out last fall's California power crisis would eventually put the state's utilities in a bind. "We saw a train wreck ahead for these companies," recalls Egan, who says his analysts quickly fired off two reports to clients warning them of the troubles facing the state's two utilities-Pacific Gas & Electric Corp. and Edison International, the parent company of Southern California Edison. On Sept. 27, the firm lowered EIX's rating from A- to BBB-, and PG&E's rating from A to BBB+.”

Grant’s Interest Rate Observer
Jim Grant Annual Conference, October 2002

“The big two-and-a-half rating agencies have not exactly covered themselves in glory during the current credit debacles. Sean Egan, co-founder of Egan-Jones Ratings Co. (which saw many disasters coming before they landed in the newspapers), will discuss debacles and opportunities yet over the horizon.”

## Enron's Senior Unsecured Ratings

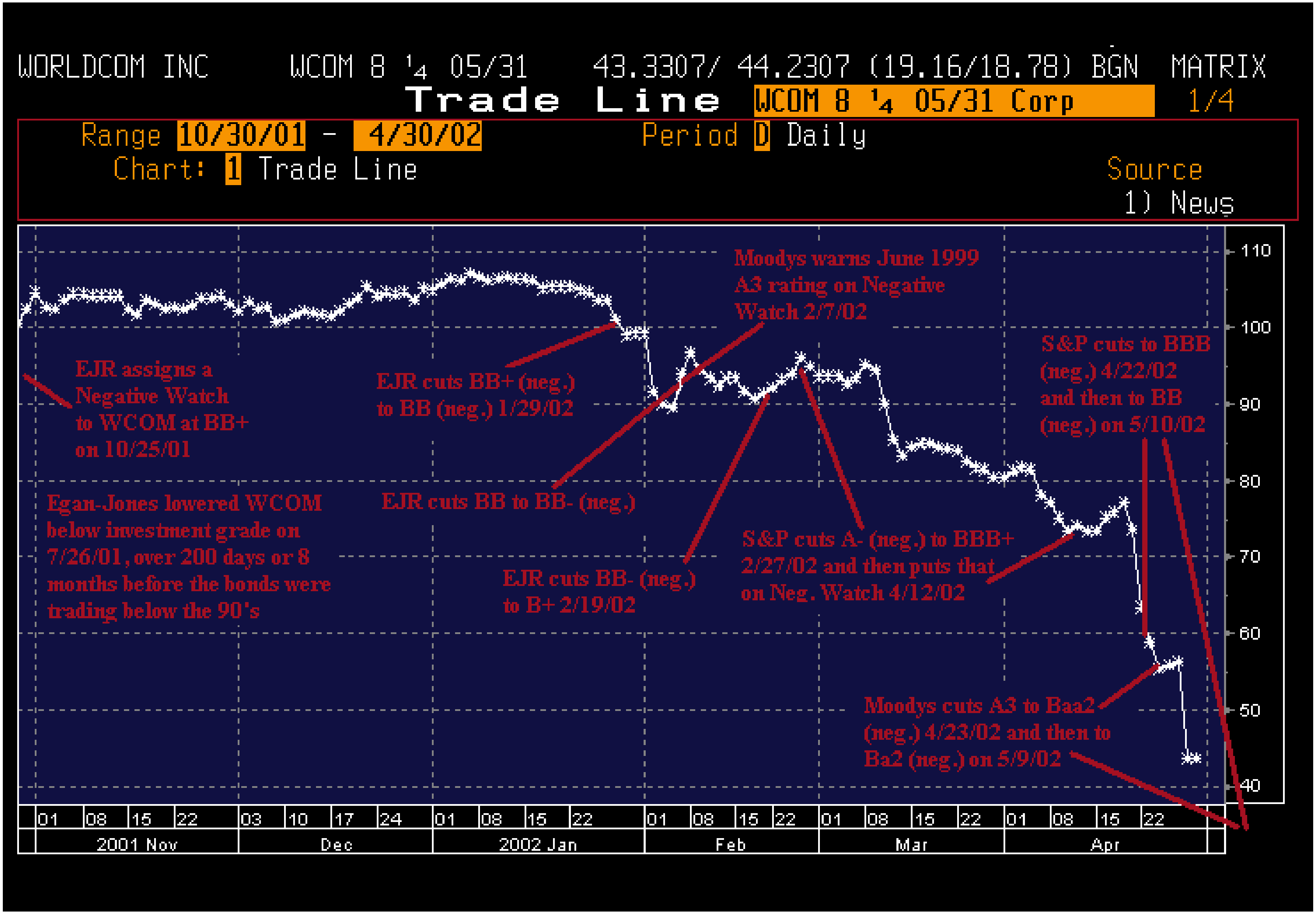
| Date | Egan-Jones* | S&P | Moody's |
|---|---|---|---|
| 4/19/2001 | BBB+ | BBB+ | Baa1 |
| →**6/27/2001** | **BBB** | BBB+ | Baa1 |
| →**8/15/2001** | **BBB/ BBB-** | BBB+ | Baa1 |
| 10/16/2001 | **BBB/ BBB-** | BBB+ | Baa1 (neg.) |
| 10/23/2001 | **BBB-** | BBB+ | Baa1 (neg.) |
| 10/24/2001 | **BBB-/ BB+** | BBB+ | Baa1 (neg.) |
| 10/26/2001 | **BB+** | BBB+ | Baa1 (neg.) |
| 10/29/2001 | **BB+/ BB** | BBB+ | Baa2 (neg.) |
| 10/31/2001 | **BB+/ BB** | BBB+ | Baa2 (neg.) |
| 11/1/2001 | **BB** | BBB (neg.) | Baa2 (neg.) |
| 11/6/2001 | **BB** | BBB (neg.) | Baa2 (neg.) |
| 11/7/2001 | **BB-/ B-** | BBB (neg.) | Baa2 (neg.) |
| 11/9/2001 | **BB** | BBB- (neg.) | Baa3 (neg.) |
| 11/21/2001 | **BB/ BB-** | BBB- (neg.) | Baa3 (neg.) |
| 11/26/2001 | **BB-/ B+** | BBB- (neg.) | Baa3 (neg.) |
| **11/28/2001** | **B+/ B-** | **BBB- (neg.)** | **Baa3 (neg.)** |
| 11/28/2001 | **C/ D** | **B-** | **B2 (neg.)** |
| 11/29/2001 | **D** | **B-** | **B2 (neg.)** |
| 11/30/2001 | **D** | **CC (neg.)** | **B2 (neg.)** |
| 12/3/2001 | **D** | **D** | **Ca** |

* Current and projected ratings

## WorldCom's Senior Unsecured Ratings

The bold indicates non-investment grade

| Date | Egan-Jones* | S&P | Moody's | Action |
|---|---|---|---|---|
| 11/1/2000 | A- (neg. watch) | A- | A3 | EJR issued neg. watch (A-) |
| 11/ 3/00 | A- (neg. watch) | A- (neg. watch) | A3 | S&P issued a neg. watch (A-) |
| 11/17/2000 | BBB+ (neg. watch) | A- (neg. watch) | A3 | EJR cut A- to BBB+ (neg. watch) |
| 2/8/2001 | BBB | A- (neg. watch) | A3 | EJR cut BBB+ to BBB |
| 2/27/01 | BBB | BBB+ | A3 | S&P cut A- to BBB+ |
| 6/25/2001 | BBB- | BBB+ | A3 | EJR cut BBB to BBB- |
| 7/26/2001 | **BB+ (neg. watch)** | BBB+ | A3 | EJR cut BBB- to BB+ (neg watch) |
| 1/29/2002 | **BB (neg. watch)** | BBB+ | A3 | EJR cut BB+ to BB (neg watch) |
| 2/ 7/02 | **BB- (neg. watch)** | BBB+ | A3 | EJR cut BB to BB- (neg watch) |
| 2/ 7/02 | **BB- (neg. watch)** | BBB+ | A3 (neg. watch) | Moody's issued a neg. watch (A3) |
| 2/19/2002 | **B+** | BBB+ | A3 (neg. watch) | EJR cut BB- to B+ |
| 4/12/02 | **B+** | BBB+ (neg. watch) | A3 (neg. watch) | S&P issued a neg. watch (BBB+) |
| 4/22/02 | **B+** | BBB | A3 (neg. watch) | S&P cut BBB+ to BBB |
| 4/23/02 | **B** | BBB | A3 (neg. watch) | EJR cut B+ to B |
| 4/23/02 | **B** | BBB | Baa2 | Moody's cut A3 to Baa2 |
| 4/25/2002 | **B-** | BBB | Baa2 | EJR cut B to B- |
| 5/ 9/02 | **B-** | BBB | **Ba2** | Moody's cut Baa2 to Ba2 |
| 5/10/02 | **B-** | **BB** | **Ba2** | S&P cut BBB to BB |
| 6/14/2002 | **B- (neg. watch)** | **BB** | **Ba2** | EJR issues neg. watch |
| 6/17/02 | **B- (neg. watch)** | **B+** | **Ba2** | S&P cut BB to B+ |
| 6/20/02 | **CCC (neg. watch)** | **B+** | **Ba2** | EJR cut B- to CCC (neg. watch) |
| 6/20/02 | **CCC (neg. watch)** | **B+** | **B1** | Moody's cut Ba2 to B1 |
| 6/26/02 | **D** | **B+** | **B1** | EJR cut CCC to D |
| 6/26/02 | **D** | **CCC-** | **B1** | S&P cut B+ to CCC- |
| 6/26/02 | **D** | **CCC-** | **Ca** | Moody's cut B1 to Ca |
| 7/ 1/02 | **D** | **CC** | **Ca** | S&P cut CCC- to CC |
| 7/17/02 | **D** | **D** | **Ca** | S&P cut CC to D |


WORLDCOM INC WCOM 8 ¼ 05/31 43.3307/ 44.2307 (19.16/18.78) BGN MATRIX
Trade Line
WCOM 8 ¼ 05/31 Corp
1/4
Range 10/30/01 - 4/30/02
Period D Daily
Chart: 1 Trade Line
Source
1) News
EJR assigns a Negative Watch to WCOM at BB+ on 10/25/01
EJR cuts BB+ (neg.) to BB (neg.) 1/29/02
Moodys warns June 1999 A3 rating on Negative Watch 2/7/02
S&P cuts to BBB (neg.) 4/22/02 and then to BB (neg.) on 5/10/02
Egan-Jones lowered WCOM below investment grade on 7/26/01, over 200 days or 8 months before the bonds were trading below the 90's
EJR cuts BB to BB- (neg.)
EJR cuts BB- (neg.) to B+ 2/19/02
S&P cuts A- (neg.) to BBB+ 2/27/02 and then puts that on Neg. Watch 4/12/02
Moodys cuts A3 to Baa2 (neg.) 4/23/02 and then to Ba2 (neg.) on 5/9/02
110
100
90
80
70
60
50
40
01 08 15 22 03 10 17 24 01 08 15 22 01 08 15 22 01 08 15 22 01 08 15 22
2001 Nov
Dec
2002 Jan
Feb
Mar
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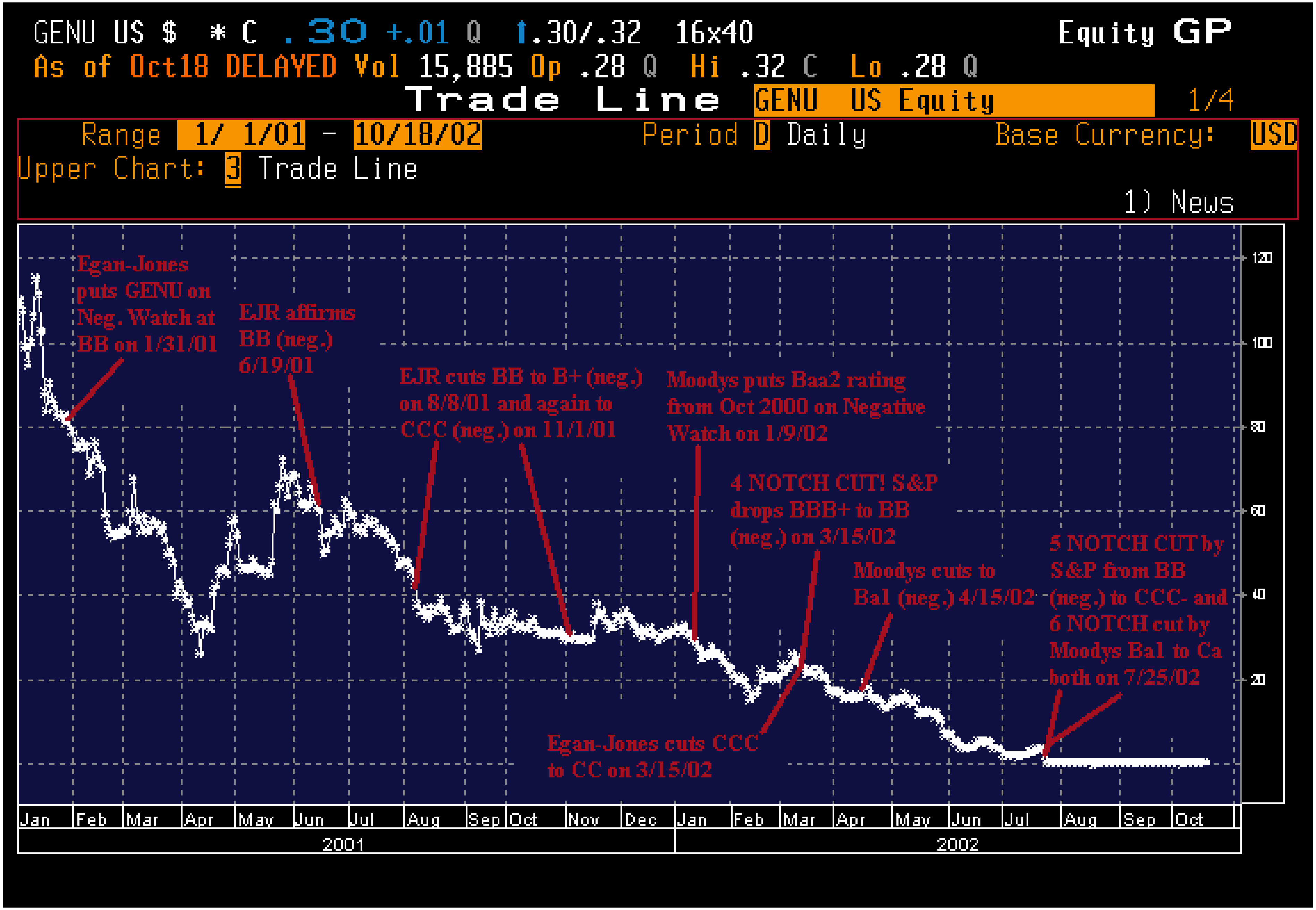
GENU US $ * C .30 +.01 Q ↑.30/.32 16x40
Equity GP
As of Oct18 DELAYED Vol 15,885 Op .28 Q Hi .32 C Lo .28 Q
Trade Line GENU US Equity 1/4
Range 1/ 1/01 - 10/18/02 Period D Daily Base Currency: USD
Upper Chart: 3 Trade Line
1) News
Egan-Jones puts GENU on Neg. Watch at BB on 1/31/01
EJR affirms BB (neg.) 6/19/01
EJR cuts BB to B+ (neg.) on 8/8/01 and again to CCC (neg.) on 11/1/01
Moodys puts Baa2 rating from Oct 2000 on Negative Watch on 1/9/02
4 NOTCH CUT! S&P drops BBB+ to BB (neg.) on 3/15/02
Moodys cuts to Ba1 (neg.) 4/15/02
5 NOTCH CUT by S&P from BB (neg.) to CCC- and 6 NOTCH cut by Moodys Ba1 to Ca both on 7/25/02
Egan-Jones cuts CCC to CC on 3/15/02
120
100
80
60
40
20
Jan Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec Jan Feb Mar Apr May Jun Jul Aug Sep Oct
2001
2002

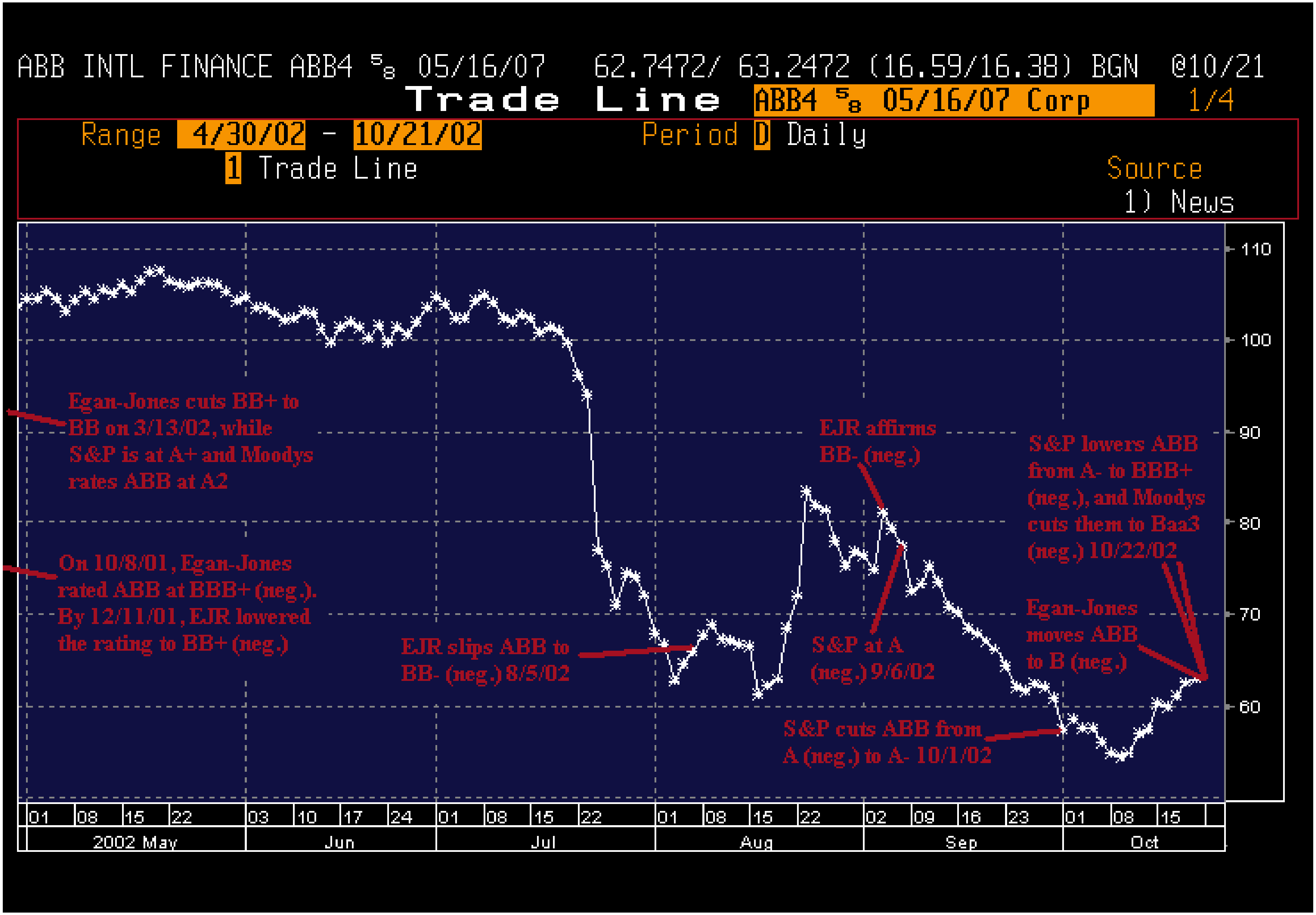

ABB INTL FINANCE ABB4 5/8 05/16/07 62.7472/ 63.2472 (16.59/16.38) BGN @10/21
Trade Line ABB4 5/8 05/16/07 Corp 1/4
Range 4/30/02 - 10/21/02 Period D Daily
1 Trade Line
Source
1) News
110
100
90
80
70
60
Egan-Jones cuts BB+ to BB on 3/13/02, while S&P is at A+ and Moodys rates ABB at A2
On 10/8/01, Egan-Jones rated ABB at BBB+ (neg.). By 12/11/01, EJR lowered the rating to BB+ (neg.)
EJR slips ABB to BB- (neg.) 8/5/02
EJR affirms BB- (neg.)
S&P at A (neg.) 9/6/02
S&P cuts ABB from A (neg.) to A- 10/1/02
S&P lowers ABB from A- to BBB+ (neg.), and Moodys cuts them to Baa3 (neg.) 10/22/02
Egan-Jones moves ABB to B (neg.)
01 08 15 22 03 10 17 24 01 08 15 22 01 08 15 22 02 09 16 23 01 08 15
2002 May
Jun
Jul
Aug
Sep
Oct